

TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Update on Federal Legislation

ITEM NUMBER: 10b

ATTACHMENT(S): 1

ACTION: X

MEETING DATE: March 6, 2003

INFORMATION:

PRESENTER: Ed Derman

IMPLEMENTATION OF THE SARBANES-OXLEY CORPORATE GOVERNANCE AND ACCOUNTING REFORM LEGISLATION

CalSTRS' federal counsel has been providing staff with regular written updates on the implementation by the Securities and Exchange Commission of various major components of the Sarbanes-Oxley corporate governance and accounting reform legislation. The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB), as the new regulator of the accounting industry. Copies of those updates are attached.

The PCAOB is expected to have an initial staff of 300 and have an annual budget in the range of \$40 to \$50 million. The PCAOB is required to annually inspect accounting firms having more than 100 corporate clients. In addition, the PCAOB is expected to adopt new auditing standards on a transitional basis to a permanent new regulatory regime. The Act requires that the PCAOB be running by April 26, a deadline which the PCAOB is expected to make.

ELK HILLS COMPENSATION

CalSTRS has received \$144 million in Elk Hills compensation from the Federal Government. Funding for the fifth installment of \$36 million for Elk Hills compensation is included in the final omnibus appropriations package adopted by Congress. CalSTRS sent a letter to House Ways and Means Committee Chair Bill Thomas, and his able staff Bob Winters and James Min, thanking them for their leadership and tireless efforts towards securing funding for the Elk Hills compensation.

For FY 2004, the Settlement Agreement between the State and the Federal Government calls for a payment in the range of \$72 million. However, the final figure remains subject to the final determination of the equity shares of the U.S. and Chevron in the Elk Hills field. As permitted under the Settlement Agreement, the U.S. Department of Energy (DOE) has temporarily held back approximately \$26 million from the Elk Hills School Lands Fund, equal to 9 percent of the Federal Government's share of an escrow fund to be tapped if the final equity determination is adverse to the Federal Government and it must pay Chevron an additional sum. Thus, a temporary hold-back for purposes of the final equity determination already has occurred.

After taking this hold-back into account, CalSTRS' federal counsel and the State Attorney General have computed the amount of the sixth installment properly due as \$59 million. The President has proposed a sixth installment at the same \$36 million as the previous five installments. The stated rationale for the lower, \$36 million level is that the equity determination is still ongoing and that the \$36 million level is a "placeholder" pending that final equity determination. The Settlement Agreement between the State and the Federal Government, however, already provides for an explicit hold-back procedure and a hold-back under that specified procedure has already occurred. There is no basis for a second hold-back to be made.

With the concurrence of CalSTRS, the State Attorney General sent a letter to the General Counsel of the U.S. Department of Energy requesting an explanation of the discrepancy in the amount of the sixth installment due to CalSTRS. The purpose for the letter is to remind the DOE of the full amount due from the Elk Hills School Lands Fund and to make clear that CalSTRS expects to receive no less than the full amount due.

PENSION SECURITY LEGISLATION AND PENSION LIBERALIZATION LEGISLATION

The House and the Senate are expected to move pension security legislation this year that is very similar to last year's legislation that became bogged down on the Senate Floor. Last month's report outlined the key provisions of this anticipated legislation, which is expected to be reintroduced shortly.

Activity on legislation regarding pension contribution limits and benefit limitations is expected to pick up shortly. The 2001 Tax Act substantially increased various limits, but in many cases are only on a phased-in basis over a substantial period of time. Representatives Rob Portman and Ben Cardin are expected to introduce the next generation of pension reform that is likely to accelerate the increase in pension contribution and benefit limitations. It will likely also remove some of the remaining technical hurdles to full portability among the different types of retirement plans.

Recently, the President issued proposals to revolutionize the savings system by adopting a series of new accounts to which contributions would be non-deductible, but withdrawals would be free of Federal income tax. All indications are that the proposals will not pass. However, House Ways and Means Chair Bill Thomas has indicated that legislation will soon be introduced by Representatives Portman and Cardin that will be the focus of the next pension reform effort in the Congress. The House and Senate GOP Leadership hopes to get an economic growth tax cut package to the President by Memorial Day.

SUMMARY OF FEDERAL LEGISLATION

Mr. Derman will provide a verbal update at the meeting.

**MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM**

Washington Monthly Report

**Implementation of the Sarbanes-Oxley
Corporate Governance and Accounting Reform Legislation**

We continue to provide STRS staff with regular written updates on the implementation by the Securities and Exchange Commission of various major components of the Sarbanes-Oxley corporate governance and accounting reform legislation.

Attached for your information are these detailed written reports on the implementation of the key provisions of the Sarbanes-Oxley legislation by the SEC rulemaking process that we have provided over the past month.

The new regulator established by the Sarbanes-Oxley legislation for the accounting industry, the Public Company Accounting Oversight Board (PCOAB), continues to organize. With the Senate confirmation this week of William H. Donaldson as the new Chairman of the Securities and Exchange Commission, the search for candidates for the Chair of the PCOAB is expected to begin in earnest. In the meantime, the PCOAB is preparing an annual budget expected to be in the range of \$40-50 million and continues to fill positions towards an expected initial staff level of 300. Approximately half of the staff will focus on the task of inspecting accounting firms. The PCAOB is required to annually inspect accounting firms having more than 100 corporate clients. In addition, the PCAOB is expected to adopt new auditing standards on a transitional basis to a permanent new regulatory regime. The Act requires that the PCAOB be certified by the SEC as being up-and-running not later than April 26, and that target is expected to be met. Nevertheless, a host of questions remain about how the PCOAB will carry out its mission and how it will interact with the SEC in such areas as enforcement and oversight of auditors' dealings with corporate board audit committees.

Senate Banking Committee Chairman Richard Shelby (R-Ala.) has indicated that Congressional oversight of the SEC's implementation of the Sarbanes-Oxley Act will be a prominent part of the Committee's agenda for the coming year. During incoming SEC Chairman Donaldson's confirmation hearing, Chairman Shelby warned him in blunt terms: "I think now is the time to put some fear into people. They need to fear you as the chairman of the SEC."

Elk Hills Compensation

STRS thus far has \$144 million in Elk Hills compensation from the Federal Government.

Funding for the fifth \$36 million installment of Elk Hills compensation is included in the final omnibus appropriations package that Congress is expected to adopt later this week.

We now turn our attention to the sixth installment of Elk Hills compensation, due for FY 2004. Of course there is a wrinkle – remember, this is Elk Hills.

For FY 2004, the Settlement Agreement between the State and the Federal Government calls for a payment in the range of \$72 million. However, the final figure remains subject to the final determination of the equity shares of the U.S. and Chevron in the Elk Hills field. This equity determination remains unresolved some six years after the sale of Elk Hills, a languorous pace even by Federal Government standards. As permitted under the Settlement Agreement, the U.S. Department of Energy has temporarily held back approximately \$26 million from the Elk Hills School Lands Fund, as 9 percent of the Federal Government's share of an escrow fund to be tapped in the event that the final equity determination is adverse to the Federal Government and it must pay Chevron an additional sum. Thus, a temporary hold-back in respect of the final equity determination already has occurred.

After taking this hold-back into account, we and the State Attorney General have computed the amount of the sixth installment properly due as \$59 million. At a time when the President's budget for the new fiscal year (FY '04) largely freezes non-defense discretionary spending at last year's level, the President has proposed a sixth installment at the same \$36 million as the previous five installments. The good news is that there is a funding request for Elk Hills. The purported rationale proffered by the supporting budget materials for the lower, \$36 million level is that the equity determination is still ongoing and that the \$36 million is a "placeholder" pending that final equity determination. Well the point is that the Settlement Agreement between the State and the Federal

Government already provides for an explicit hold-back procedure and a hold-back under that specified procedure already has occurred. There is no basis for a second hold-back to be made.

The State Attorney General, after consulting with us, has sent a letter to the General Counsel of the U.S. Department of Energy seeking an explanation for the discrepancy in the amount of the sixth installment. This letter is intended to serve several purposes: (1) to make clear to DoE that we are on to them; (2) to preserve STRS's rights to the full amount in the Elk Hills School Lands Fund and the hold-back that already has occurred, so that DoE or the Hill cannot argue we somehow waived our rights to the full amount of the sixth installment; and (3) to demonstrate to any Congressional appropriator thinking of applying a "haircut" to the sixth installment because of budgetary pressure that such a haircut already has been imposed by DoE.

We are consulting with our Congressional champions on the best course of action on the sixth installment and will keep you apprised.

Pension Security Legislation and Pension Liberalization Legislation

As we reported last month, the House and the Senate are expected to move pension security legislation this year that is very similar to the legislation passed by the House last year and reported out by the Senate Finance Committee that became mired down on the Senate Floor. Last month's report outlined the key provisions of this expected legislation, which has not yet been reintroduced in the new Congress. This pension security legislation is expected to be reintroduced shortly.

There also is expected to be legislative activity on the matter of pension contribution and benefit limitations. As you know, the 2001 Tax Act substantially increased various of these limits, but in many cases only on a phased-in basis over a substantial period of time. Reps. Rob Portman (R-Ohio) and Ben Cardin (D-Md.), who historically have led the bipartisan pension reform effort in the House, are expected to introduce very shortly the "next generation" of pension reform that is likely to accelerate the increase in pension contribution and benefit limitations currently being phased in, remove some of the remaining technical hurdles to full portability among different types of retirement plans, and adopt other "reforms". We would expect to have more detail for you in next month's report.

You may have heard a lot recently about the President's new proposals to "revolutionize" the savings system by adopting a series of new accounts to which contributions would be non-deductible but withdrawals from which would be free of

Federal income tax. Don't bother trying to master the details of these proposals or to try to ferret out all of the market implications. They're not going to happen. Even the President's most loyal base in the Congress – the House GOP Leadership – has stated bluntly that the proposals are going nowhere. Instead, House Ways and Means Chairman Bill Thomas (R-Bakersfield) has indicated that the soon to be introduced Portman-Cardin legislation will be the focus of the next pension reform effort in the Congress, which Chairman Thomas indicated is likely to be taken up after the President's "economic growth" tax cuts are addressed in legislation. The House and Senate GOP Leadership hopes to get an "economic growth" tax cut package to the President by Memorial Day.

John S. Stanton
Hogan & Hartson L.L.P.

Washington, D.C.
February 12, 2003

HOGAN & HARTSON LLP

SEC update

Auditor Independence

February 6, 2003

On January 28, the SEC published final rules under Section 208 of the Sarbanes-Oxley Act regarding auditor conflicts of interest, the provision of non-audit services by a company's outside auditor, required rotation of audit partners and other matters relating to auditor independence. These rules significantly strengthen rules regarding auditor independence adopted by the SEC in November 2000 and provide for enhanced audit committee oversight of accounting engagements. The new rules, which are described in Release No. 34-47265, will be effective on May 6, 2003, but application of the rules will be subject to the transition provisions described below. Portions of the rules that are applicable solely to registered investment companies are not discussed in this *SEC Update*.

Other new rules described in Release No. 34-47265 require additional proxy statement disclosure concerning services provided by, and fees paid to, a public company's outside auditor and provide for increased communications between a company's audit committee and outside auditor. These rules, together with related final rules governing retention of audit records (described in Release No. 34-47241, dated January 24, 2003), are addressed in a separate *SEC Update* we are issuing today.

Avoiding Conflicts of Interest in Employment Relationships

The new rules impose a one-year "cooling-off" period before the lead partner, the concurring partner or any other member of an issuer's audit engagement team who provides more than ten hours of audit, review or attest services to the issuer during the annual audit period may be employed by the issuer in a "financial reporting oversight role."

Restriction on Employment by "Issuer." The final rules apply only to employment relationships entered into between the "issuer" and members of the audit engagement team. As proposed, the cooling-off period would have applied to employment by the "audit client." In modifying this standard, the SEC agreed with commenters that employment by an "audit client" might be difficult to monitor because of the potentially broad scope of that term, particularly in

situations where a member of the audit engagement team begins employment with an affiliate of the audit client.

Affected Members of Audit Engagement Team. Under the new rules, an individual, other than the lead or concurring partner, must provide more than ten hours of audit, review or attest services during the annual audit period to be considered a member of the audit engagement team. In adopting this minimum service threshold, the SEC recognized that there are members of the audit engagement team who spend a relatively small amount of time on audit-related matters of the issuer and who likely have not had significant interaction with the issuer's audit engagement team or management. Because of their roles in the engagement, the lead and concurring partners are always considered members of the audit engagement team. Under two additional exceptions to the cooling-off requirement, auditor independence will not be compromised by an otherwise prohibited employment that results from (1) a business combination between the issuer and an entity that employed the audit engagement team member at the time of the business combination or (2) an emergency or other unusual situation, if the audit committee determines that the employment relationship is in the interest of investors.

Scope of "Financial Reporting Oversight Role." A "financial reporting oversight role" is defined in the final rules to mean a role in which a person is in a position to, or does, exercise influence over the contents of the issuer's financial statements or anyone who prepares the financial statements. The rules indicate that such a role is performed by members of the company's board of directors or similar management or governing body, by the company's CEO, president, CFO, COO, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting or treasurer, or by individuals serving in any equivalent position.

Calculation of Cooling-Off Period. The cooling-off period is a one-year period preceding the date on which audit procedures commenced for the fiscal period that included the date of the issuer's initial employment of a member of the audit engagement team. The audit procedures are deemed to have commenced for the current audit engagement period on the day after the issuer files with the SEC the prior year's annual report on Form 10-K, 10-KSB, 20-F or 40-F. The audit engagement period for the current year is deemed to conclude on the day on which the issuer files the current year's periodic annual report. The adopting release contains helpful examples on how to calculate the cooling-off period.

Effective Date. The rules are effective for employment relationships with an issuer that commence after May 6, 2003.

Non-Audit Services and Audit Committee Approval of Auditor Engagements

The new rules significantly strengthen the rules on auditor independence adopted by the SEC in November 2000, including the rules related to the non-audit services that, if provided to an audit client, would impair the auditor's independence. The rules (1) substantially incorporate into the SEC rules defining auditor independence the list of prohibited non-audit services contained in Section 201(a) of the Act, (2) eliminate from the existing auditor independence rules many of the exceptions and exemptions that have permitted auditors to provide certain of the prohibited services in limited situations and (3) clarify the scope of prohibited non-audit services. The rules apply only to non-audit services provided by independent accountants to their own audit clients. The new rules also require that a company's audit committee

pre-approve all engagements for audit, review or attest services and the auditor's provision of any permitted non-audit services.

Prohibited Non-Audit Services. Under the new rules, an auditor performing audit services for a public company will not be considered to be independent if it provides to the same client during the audit and professional engagement period any of the following ten categories of non-audit services (subject to the limited exception described below):

1. Bookkeeping or other services related to the accounting records or financial statements of the audit client;
2. Financial information systems design and implementation;
3. Appraisal or valuation services, fairness opinions or contribution-in-kind reports;
4. Actuarial services;
5. Internal audit outsourcing services;
6. Management functions;
7. Human resources;
8. Broker-dealer, investment adviser or investment banking services;
9. Legal services; and
10. Expert services unrelated to the audit.

The auditor may not provide services in the first five categories "unless it is reasonable to conclude" that the results of the services will not be subject to audit procedures during an audit of the company's financial statements. The SEC stated that it adopted this formulation of the required finding to narrow the circumstances in which the exception may be invoked to justify the provision of the applicable services. The SEC further indicated that there is a "rebuttable presumption" that the first five categories of services are subject to audit procedures and are therefore impermissible.

Tax Services. In the adopting release, the SEC stated that it "reiterates its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence." The SEC recognizes that permissible tax services can include the preparation of tax returns, tax compliance, tax planning, tax recovery and other tax-related services, and in some circumstances (such as review of tax accruals) may constitute a part of audit services. The SEC clarified that auditors may provide tax services to an audit client if the audit committee has pre-approved the services and the services would not violate any of the three basic principles of independence referred to below. As examples of tax services not satisfying those principles, the SEC cites services where the auditor serves as an advocate for the client before a tax court, district court or federal court of claims or formulates tax strategies designed to minimize a company's tax obligations. In particular, the SEC admonished audit committees to scrutinize the retention of an auditor in a transaction initially recommended by the auditor if the sole business purpose of the transaction may be tax avoidance or if the tax treatment of the transaction may not be supported by the Internal Revenue Code.

Audit Committee Pre-Approval of Non-Audit Services. Auditors will be able to provide non-audit services that are not on the list of specifically prohibited services if the company's audit committee approves those services in advance. The rules require audit committee pre-approval by either of the two following means, which the SEC indicated are "equally acceptable":

- Pre-approval by audit committee. This requirement may be fulfilled either by (1) approval by the full audit committee before the auditor is engaged to provide the service or (2) delegation of the committee's pre-approval authority to one or more independent members of the audit committee, provided that any decisions made under delegated authority are reported to the full audit committee at its scheduled meetings.
- Pre-approval pursuant to policies and procedures established by the audit committee. This approach provides an alternative to pre-approval by the audit committee or a committee member on an engagement-by-engagement basis. Any policies and procedures established by the audit committee for these purposes must be "detailed as to the particular service" and may not delegate the audit committee's responsibilities to management. Pre-approval in this manner will require the audit committee to be informed "on a timely basis" of any engagement for non-audit services authorized in accordance with the policies and procedures. The SEC indicated that it expects that audit committees will establish a maximum period between the date on which a service is pre-approved and the date on which the auditor is engaged to provide the service.

In pre-approving permitted non-audit services, the audit committee or its delegated members should determine that provision of the services is consistent with the basic principles of independence that the auditor cannot (1) function in the role of management, (2) audit its own work or (3) serve in an advocacy role for its client. These basic principles also should form the basis for any pre-approval policies and procedures established by the audit committee. Because the rules define the term "audit committee" to mean the full board of directors if a company does not have a separate audit committee, pre-approval requirements may be fulfilled by the full board of directors of companies that do not have a standing audit committee.

De Minimis Exception to Pre-Approval Requirement. The new rules contain a *de minimis* exception to the pre-approval requirement. Auditors will be able to provide non-audit services without pre-approval if (1) the aggregate amount of all such services does not exceed 5% of the total revenues paid by the company to the auditor during the fiscal year in which the services are provided, (2) the services were not recognized by the company to be non-audit services at the time of the engagement and (3) the services are promptly brought to the attention of the audit committee and approved by the audit committee or one or more designated committee members before completion of the audit. Companies should not generally seek to rely on this exception, because it is intended to cover mistakes or miscommunications that result in the company's audit firm providing services that, in hindsight, were not within the scope of either the audit engagement or any non-audit services previously approved by the audit committee.

Audit Committee Pre-Approval of Auditing Engagements. The final rules require that all engagements for audit, review or attest services be pre-approved by the audit committee or entered into pursuant to pre-approval policies and procedures established by the audit committee in accordance with the requirements described above.

Effective Dates. The rules requiring audit committee pre-approval apply to all audit, review and attest services and all non-audit services that are entered into after May 6, 2003. The provision of any of the prohibited non-audit services described above before May 6, 2004 will not impair an auditor's independence if (1) those services are furnished pursuant to contracts

in existence on May 6, 2003 and (2) the provision of those services did not impair the auditor's independence under pre-existing requirements. The auditor will have 12 months from May 6, 2003 to complete non-audit services under arrangements entered into before May 6, 2003, even if the audit committee did not pre-approve those services.

Audit Partner Rotation

Section 203 of the Sarbanes-Oxley Act requires the lead partner and concurring partner on an audit engagement to rotate off that engagement every five years. The new rules on audit partner rotation extend the rotation requirement to all "audit partners." In addition to the lead and concurring partners, "audit partners" include partners (1) who have responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements, (2) who maintain regular contact with a company's management and audit committee, (3) who serve the client at the company or parent level, other than "specialty" partners, and (4) who serve as the lead partner on a subsidiary having assets or revenues that constitute 20% or more of the company's consolidated assets or revenues. Partners assigned to "national office" duties who may be periodically consulted on specific accounting issues are not subject to the rotation requirement. Lead and concurring partners will not be able to serve on a client's engagement for more than five consecutive years and, once off the engagement, will have to wait five years before serving on that client's engagement again. All other partners subject to the rule will not be able to serve on a client's engagement for more than seven consecutive years and, once off the engagement, will have to wait two years before serving on that client's engagement again. The SEC expects that audit firms will stagger the rotation of partners to ensure that there is continuity of expertise. A limited exemption to the rotation requirement is available for audit firms with fewer than ten partners and fewer than five audit clients that are issuers. For an audit firm to qualify for this exemption, all of its engagements subject to the rules must be reviewed by the Public Company Accounting Oversight Board at least once every three years.

Effective Dates. The rotation requirements applicable to the lead partner and audit partners other than the concurring partner are effective as of the end of the company's first fiscal year after May 6, 2003. To facilitate the process of staggering the rotation of the lead and concurring partners, the rotation requirements applicable to the concurring partner are effective as of the end of the company's second fiscal year after May 6, 2003. In determining time served on an audit by lead and concurring partners, time served as the lead or concurring partner before May 6, 2003 must be included. In determining time served on an audit for all other audit partners and for all partners with foreign accounting firms who are subject to rotation requirements, time served on the audit engagement team before the first day of the company's fiscal year beginning on or after May 6, 2003 does not need to be included.

Auditor Compensation

The final rules provide that an auditor is not independent if, at any time during the audit and professional engagement period, any "audit partner" serving as a member of the audit engagement team earns "compensation" based on performing, or procuring an engagement to perform, non-audit services. The purpose of this restriction is to reduce an auditor's economic incentive to compromise its accounting judgments in order to avoid jeopardizing the prospect for future non-audit business. For this purpose, "audit partners" will include the same persons who are subject to the audit partner rotation requirements. "Compensation" could include any form of cash or other assets distributed to the audit partner, including any income or benefit based on an evaluation of the partner's performance.

Effective Date. The restriction on auditor compensation will be effective in the fiscal periods of the auditor that commence after May 6, 2003.

Analysis

Some of the new rules, such as those that address prohibited non-audit services, modify or supplement existing rules, while others, such as those that address employment-related conflicts of interest, reflect approaches to auditor independence issues that have been debated vigorously over the past several years. Certain rules, such as those related to auditor compensation, are directed at audit firms and will have only an indirect impact on audit clients.

The requirement for audit partner rotation is likely to be one of the most troubling for public companies, particularly companies that use smaller audit firms or that operate in industries requiring specialized accounting expertise. Public companies should begin to discuss with their outside audit firm how the firm plans to comply with this requirement on their engagement, and companies considering new engagements should discuss the staffing issue to ensure the firm has enough depth to continue providing the expected level of service.

The final rules on non-audit services provide some helpful guidance, but companies will still be called upon to make difficult judgments about whether certain services should be permitted. Audit firms likely will develop their own guidelines concerning the types of services that may impair their independence, but audit committee members should bear in mind that it also is the responsibility of the audit committee to make these decisions.

The new rules permit the audit committee to establish policies and procedures for pre-approving non-audit services and auditing engagements. This approach will be particularly useful for large companies, including those with significant international operations, for which audit committee approval of audit or non-audit services on an engagement-by-engagement basis would be administratively cumbersome. Audit committees that establish pre-approval policies and procedures should be mindful that, under the new related rules discussed in the other *SEC Update* we are issuing today, those policies and procedures and the percentages of fees paid or earned for pre-approved services will have to be disclosed annually in proxy statements or annual reports.

For more information about the matters discussed in this *SEC Update*, please contact the Hogan & Hartson L.L.P. attorney with whom you work, any of the attorneys below who contributed to this *Update* or any of the attorneys who are part of our securities group listed at <http://www.hhlaw.com/secattorneys/>.

Peter J. Romeo (Co-Editor)
pjromeo@hhlaw.com

Charles E. Sieving
cesieving@hhlaw.com

Richard J. Parrino (Co-Editor)
rjparrino@hhlaw.com

www.hhlaw.com

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SEC update

Auditors and Audit Committees: New Disclosures, Required Communications and Retention of Records

February 6, 2003

On January 28, the SEC published final rules under Section 208 of the Sarbanes-Oxley Act that require additional disclosure concerning services provided by, and fees paid to, a public company's outside auditor and provide for specified types of communications between a company's audit committee and its auditor. The new rules, which are described in Release No. 34-47265, will be effective on May 6, 2003, but application of the rules will be subject to the transition provisions described below. In related final rules that implement Section 802 of the Act, the SEC has required audit firms to retain their workpapers and other records relating to audits and financial statement reviews for a period of seven years. These rules (described in Release No. 34-47241, dated January 24, 2003) will be effective on March 3, 2003 and require compliance for audits and reviews completed on or after October 31, 2003. Portions of the final rules that are applicable solely to registered investment companies are not discussed in this *SEC Update*.

Other new rules described in Release No. 34-47265 address auditor conflicts of interest, the provision of non-audit services by a company's outside auditor, required rotation of audit partners and other matters relating to auditor independence. These rules are addressed in a separate *SEC Update* we are issuing today.

New Disclosure Requirements

Fee Disclosures. The new rules have expanded the existing requirements for proxy statement disclosure of fees billed by a company's auditor. Companies will have to disclose fees grouped according to the following four categories:

- ***Audit fees.*** This category includes fees generated by all services performed to comply with generally accepted auditing standards. Certain services, such as tax services and accounting consultations, may not be billed as audit services. An appropriate allocation of fees for those services may be included in this category, however, to the extent that such services are necessary to comply with generally accepted auditing standards.

- **Audit-related fees.** This category includes fees generated by assurance and related services that are traditionally performed by the auditor. These services include employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services that are not required by statute or regulation, and consultation concerning financial accounting and reporting standards.
- **Tax fees.** This category includes fees for all services performed by professional staff in the auditor's tax division, except those services related to the audit. Companies should disclose fees for tax compliance, tax planning and tax advice in this category.
- **All other fees.** This category will remain unchanged from that under the current proxy rules, except that fees, if any, generated by financial information systems implementation and design services will be disclosed in this category. As described in a separate *SEC Update* we are issuing today, the new rules have included "financial information systems implementation and design" services among the non-audit services that auditors are prohibited from providing to their audit clients. As a result, the new rules have eliminated the corresponding disclosure category for these services.

Acknowledging in the adopting release that fees for some services may be difficult to classify according to these categories, the SEC encourages issuers and their auditors to contact the SEC staff to discuss appropriate classifications.

Qualitative Disclosure of Services Provided. The new rules require companies to describe, in qualitative terms, the types of services provided under each fee category other than "audit fees."

Disclosure Required for Two Fiscal Years. The information on fees must be presented for the two most recent fiscal years, so that investors will have comparative information about the fees. Under the current rules, fee information is required only for the most recent fiscal year.

Disclosure of Pre-Approval Policies and Procedures. As described in our companion *SEC Update*, the new rules authorize audit committees to pre-approve audit services and permitted non-audit services through the establishment of policies and procedures instead of on an engagement-by-engagement basis. The new rules require companies to describe these pre-approval policies and procedures in their proxy statements or annual reports. (Alternatively, companies may include a copy of the policies and procedures in these filings.) The description is required to be accompanied by a breakdown of the percentage of fees in each of the "audit-related fees," "tax fees" and "all other fees" categories that were authorized under the pre-approval policies and procedures. To the extent that permitted non-audit services are provided under a *de minimis* exception to the pre-approval requirement, the company must disclose the percentage of the total fees paid to the auditor under each of the foregoing three categories in which the *de minimis* exception was applied.

Disclosures in Proxy Statement or Annual Report. The Act requires companies to provide disclosure in their periodic reports concerning auditor fees and the audit committee's pre-approval policies and procedures. To implement this requirement, the final rules require that this disclosure be included in a company's proxy statement, which may be incorporated by reference into the company's annual report. Companies, such as foreign private issuers, that do not file proxy statements would be required to include the disclosure in their annual report on Form 10-K, Form 20-F or Form 40-F.

Effective Date. The foregoing disclosure provisions will be effective for periodic annual filings for the first fiscal year ending after December 15, 2003. In the adopting release, the SEC encouraged companies who issue periodic annual filings before that date to comply with these disclosure provisions before effectiveness.

Communications with Audit Committees

Section 204 of the Act directs the SEC to adopt rules requiring auditors to communicate certain information to their audit clients on a timely basis. The SEC believes that generally accepted auditing standards and the securities laws already require audit firms to communicate similar information to their clients, but has adopted rules that provide additional guidance. Under the new rules, auditors are required to communicate to audit committees regarding the following matters:

1. **Critical accounting policies and practices used by the company in the preparation of its financial statements.** The SEC recommends that auditors refer to its December 2001 cautionary advice and May 2002 rule proposal for guidance on the types of matters under this topic that should be communicated to the audit committee.
2. **Alternative accounting treatments under generally accepted accounting principles used by the company.** The rules require communication, either orally or in writing, by auditors to audit committees of all alternative treatments within GAAP for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the auditor. This rule is intended to cover recognition, measurement and disclosure considerations related to the accounting for specific transactions, as well as general accounting policies.
3. **Other material written communications between the auditor and management.** This discussion is intended to ensure that the audit committee has all material information it needs to perform its management and auditor oversight role. The SEC stated that it expects covered written communications will include, among other items, management representation letters, engagement letters, independence letters, reports and recommendations on internal controls, schedules of unadjusted audit differences and a list of any adjustments and reclassifications that are not recorded.

The required communications should occur before any audit report is filed with the SEC in a current or periodic report, proxy statement or registration statement. As a result, communications will occur at least annually, but more frequent communication may be required or advisable. The new rules do not require the applicable communications to be made in writing. The SEC indicated, however, that it expects that the auditor and the audit committee will document these communications.

Effective Date. The rules will be effective on May 6, 2003.

Retention of Audit Records

In related final rules directed at audit firms, the SEC has implemented Section 802 of the Sarbanes-Oxley Act by requiring that auditors retain, for a period of seven years, records relating to the audit or review of a company's financial statements. The seven-year period will begin to run from the conclusion of the audit or review. The final rules require that the auditor retain records "relevant to the audit or review," including workpapers and other documents that form the basis for the audit or review of an issuer's financial statements, as

well as memoranda, correspondence, communications, and other documents and records (including electronic records) that meet two criteria. The materials would have to (1) be created, sent or received in connection with the audit or review and (2) contain conclusions, opinions, analyses or financial data related to the audit or review. The phrase "records relevant to the audit or review" was added to the final rules in response to comments on the proposed rules and to track more closely the wording in Section 802 of the Act. The covered materials would include not only those that support an auditor's conclusions about the financial statements, but also those that cast doubt on those conclusions. There currently is no generally accepted auditing standard that requires auditors to retain such a broad range of documents or that specifies a period of time for retention, so the new rules will provide a uniform standard.

Analysis

The enhanced disclosures under the new rules reflect the SEC's approach of expanding disclosure requirements in this area in tandem with new substantive obligations imposed in accordance with the Sarbanes-Oxley Act. Audit committees that take advantage of pre-approval policies and procedures to discharge their new duties will have to be mindful that those policies and procedures and the percentages of fees paid or earned for pre-approved services will have to be disclosed annually in proxy statements or annual reports. The final rules that address auditor communications with the audit committee represent a codification of practices that an increasing number of issuers have embraced in recent years. The rules related to record retention are directed at audit firms and should have only an indirect impact on audit clients.

For more information about the matters discussed in this *SEC Update*, please contact the Hogan & Hartson L.L.P. attorney with whom you work, or any of the attorneys below who contributed to this *Update*, or who are part of our securities group listed at <http://www.hhlaw.com/secattorneys/>.

Peter J. Romeo (Co-Editor)

pjromeo@hhlaw.com

Charles E. Sieving

cesieving@hhlaw.com

Richard J. Parrino (Co-Editor)

riparrino@hhlaw.com

www.hhlaw.com

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SEC update

Disclosure of Non-GAAP Financial Information

January 31, 2003

On January 15, the SEC adopted final rules under Section 401(b) of the Sarbanes-Oxley Act addressing the disclosure of financial information not calculated and presented in accordance with generally accepted accounting principles in the United States. The new rules are described in Release No. 34-47226 (dated January 22). Effective as of March 28, 2003, a new disclosure regulation, Regulation G, will apply to "non-GAAP financial measures" used in press releases and all public disclosures other than SEC filings. Non-GAAP financial measures included in SEC filings will be subject to new provisions included in Item 10 of Regulation S-K and Item 10 of Regulation S-B. The amendments to Item 10 will first apply to any quarterly or annual report filed with the SEC for fiscal periods ending after March 28, 2003. The new rules, with some modifications, will apply to foreign private issuers.

Background

The SEC previously has expressed concern with non-GAAP presentations of financial information. In ASR No. 142 (1973), the SEC indicated that the use of non-GAAP financial measures "has led to conflicting results and confusion for investors." Later, in Release No. 33-8039 (2001), it warned companies about the dangers of presenting earnings and operating results on the basis of methodologies other than GAAP, saying that in some instances a non-GAAP presentation "can mislead investors if it obscures GAAP results." Soon after issuing the 2001 release, the SEC brought an enforcement action in 2002 against Trump Hotels & Casino Resorts, Inc., in which the SEC found the use of non-GAAP information to be materially misleading. In the SEC's view (as expressed in the 1973 release), "it is not an appropriate solution to have each company independently decide what the best measure of its performance should be and present that figure to its shareholders as Truth."

Approach of the New Rules

To address these concerns, the final rules impose new disclosure requirements on companies that include "non-GAAP financial measures" in their SEC filings or in their earnings releases or other public disclosures. The rules require companies using these measures also to present (1) the "most directly comparable" GAAP financial measure and (2) a reconciliation of the differences between the non-GAAP financial measure presented and the most directly comparable GAAP financial measure. In SEC filings, this GAAP-related presentation required by the new rules must be supplemented by the additional disclosures described below.

Definition of "Non-GAAP Financial Measure"

The SEC adopted the term "non-GAAP financial measure," rather than "pro forma financial information," for purposes of the new rules to avoid confusion with existing SEC rules and regulations that use the term "pro forma" in a different context. The definition of "non-GAAP financial measure" is contained in Regulation G. The amendments to Item 10 of Regulation S-K and Regulation S-B apply to the same categories of non-GAAP financial measures that are covered by Regulation G.

Definition in Regulation G. Under Regulation G, a "non-GAAP financial measure" is defined as a numerical measure of a company's historical or future financial performance, financial position or cash flows that:

1. Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable GAAP measure calculated and presented in the company's income statement, balance sheet or statement of cash flows (or equivalent statements); or
2. Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure so calculated and presented.

A non-GAAP financial measure does not include operating and other financial measures and ratios or statistical measures that are calculated using only one or both of (1) financial measures calculated in accordance with GAAP or (2) other measures (such as operating measures) that are not non-GAAP financial measures.

Examples of Non-GAAP Financial Measures. In the adopting release, the SEC cited the following as examples of "non-GAAP financial measures" covered by the new rules:

- Earnings before interest and taxes ("EBIT") and earnings before interest, taxes, depreciation and amortization ("EBITDA");
- A measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring";
- A measure of operating margin in which the revenue component, the operating income component or both components of the calculation are not calculated in accordance with GAAP;
- A measure of performance that is different from the measure presented in the financial statements, such as income or loss before taxes, or net income or loss, as calculated in accordance with GAAP; and

- A measure of liquidity that is different from cash flow or cash flow from operations as calculated in accordance with GAAP.

Examples of Other Types of Financial Measures. In the adopting release, the SEC provided the following examples of financial measures that are not "non-GAAP financial measures" covered by the new rules:

- Operating and other statistical measures, such as unit sales, numbers of employees, numbers of subscribers or numbers of advertisers;
- Amounts of expected indebtedness or expected debt repayments;
- Estimated revenues or expenses of a new product line, so long as the estimates are calculated in accordance with GAAP;
- Measures of profit or loss and total assets for each business segment required to be disclosed in accordance with GAAP;
- Sales per square foot or same-store sales, provided the sales figures are calculated in accordance with GAAP; and
- Financial measures, such as measures of capital or reserves, calculated for regulatory purposes.

Regulation G

Regulation G generally applies to non-GAAP financial measures presented in earnings releases and other public disclosures, other than SEC-filed documents. Regulation G does not apply to non-GAAP financial measures (including measures that represent projections or forecasts of results of proposed business combinations) included in a disclosure relating to a proposed business combination, the resulting entity or parties to the transaction if the disclosure is contained in a communication subject to the SEC's communications rules applicable to business combination transactions.

Under the reconciliation requirement of Regulation G, a company must include the following information as part of the disclosure or release of a non-GAAP financial measure:

1. a presentation of the "most directly comparable financial measure calculated and presented in accordance with GAAP"; and
2. a quantitative reconciliation, by schedule or other clearly understandable method, of the differences between the non-GAAP financial measure presented and the most directly comparable GAAP financial measure or measures.

The SEC stated that companies will have the flexibility to make appropriate determinations concerning the most directly comparable GAAP financial measures. It emphasized, however, that the SEC staff's view continues to be that (1) non-GAAP financial measures that measure cash or "funds" generated from operations (liquidity) should be balanced with disclosure of amounts from the statement of cash flows (cash flows from operating, investing and financing activities), and (2) non-GAAP financial measures that depict performance should be balanced with net income, or income from continuing operations, taken from the statement of operations.

If GAAP financial measures are not available for reconciliation of non-GAAP financial measures that are forward-looking, the company must disclose this fact, must provide reconciling information that is available without unreasonable effort, and must identify the information that is unavailable and disclose the probable significance of this information.

If a non-GAAP financial measure is released orally, telephonically, by webcast, by broadcast or by similar means, the company may provide the information required by Regulation G by (1) posting that information on the company's web site and (2) disclosing during its presentation the location and availability of the required accompanying information.

In addition to the reconciliation requirement, Regulation G contains a general disclosure requirement that prohibits material misstatements or omissions in presentations of material non-GAAP financial measures. Thus, a disclosure under Regulation G that is materially deficient will expose the violator to potential liability under Regulation G as well as under the anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Amendments to Regulations S-K and S-B and to Form 20-F

The SEC has amended Item 10 of Regulation S-K and Regulation S-B, and incorporated into Form 20-F the amendments to Item 10 of Regulation S-K, to provide guidance on the use of non-GAAP financial measures in SEC-filed documents, including registration statements filed under the Securities Act and reports and proxy statements filed under the Exchange Act. The amendments prescribe required disclosures and prohibit specified disclosures relating to non-GAAP financial measures. The requirements and prohibitions for filed information are more extensive than those set forth in Regulation G.

Additional Required Disclosures. The amendments require a company that intends to include a non-GAAP financial measure in an SEC filing to disclose, in addition to the information required by Regulation G, the following information:

1. A statement of the reasons why management believes that the presentation of the non-GAAP financial measure provides useful information to investors regarding the company's financial condition and results of operations; and
2. If material, a statement disclosing any additional, previously undisclosed purposes for which management uses the non-GAAP financial measure.

Prohibited Practices. The amendments to Item 10 of Regulation S-K and Regulation S-B contain a list of practices that a company must avoid when making the required disclosures in its SEC filings. A company may not, in its SEC filings:

- Present non-GAAP financial measures with greater authority or prominence than comparable GAAP financial measures;
- Exclude from non-GAAP liquidity measures any charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, except that it will be permissible to exclude these charges and liabilities from EBIT and EBITDA;
- Adjust a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years or (2) there was a similar charge or gain within the two prior years;
- Present non-GAAP financial measures on the face of the company's GAAP financial statements or in the accompanying notes;
- Present non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; or
- Use titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP measures.

In a change from the proposed rules, the final amendments do not prohibit the use of non-GAAP per share measures.

Companies Subject to the New Rules

The new rules generally apply to all companies, other than registered investment companies, that either have a class of securities registered under Section 12 of the Exchange Act or are required to file reports under Section 15(d) of the Exchange Act.

Regulation G applies to foreign private issuers, subject to a limited exception. Regulation G does not apply to public disclosure of a non-GAAP financial measure by, or on behalf of, a foreign private issuer if:

- The securities of the issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- The non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP; and
- The disclosure is made by or on behalf of the issuer outside the United States or is included in a written communication that is released by or on behalf of the issuer outside the United States.

The exemption from Regulation G for foreign private issuers will apply even if a written communication is released contemporaneously or subsequently in the United States or information appears on web sites available in the United States, so long as the written communication or other information is not targeted at persons in the United States.

Foreign private issuers generally are subject under Form 20-F to the same requirements as domestic companies with respect to the use of non-GAAP financial measures in SEC filings. A foreign private issuer, however, will be permitted to include in a Form 20-F filing a non-GAAP financial measure that otherwise would be prohibited if the measure is (1) required or expressly permitted under the generally accepted accounting principles used in the issuer's primary financial statements included in the filing and (2) included in the foreign private issuer's annual report or financial statements used in the issuer's home country jurisdiction or market.

Analysis

These new rules impose meaningful conditions on the use of non-GAAP financial measures. Companies that previously viewed earnings releases, reports to shareholders, web site postings and other public announcements as a form of "free writing" will have to be mindful of their increased exposure if they present non-GAAP financial measures in these communications. Companies that regularly utilize non-GAAP financial measures may have to modify their prior disclosures to meet the new requirements. Many companies are familiar with issues involved in the use of non-GAAP measures because of their involvement in industry-based efforts to formulate standard supplemental non-GAAP financial disclosures. Previous SEC staff positions on non-GAAP measures, many of which are codified in the new rules, also have provided guidance on reconciliation and related presentation issues. One of the biggest challenges under the new rules for some companies will be selecting the most

directly comparable GAAP measures to balance the non-GAAP presentation. Certain reconciliations could require substantially more disclosure than under prior disclosure practice. Once issuers and investors develop experience with these disclosures, reporting processes for non-GAAP financial measures should be strengthened and become more uniform.

For more information about the matters discussed in this SEC Update, please contact the Hogan & Hartson L.L.P. attorney with whom you work, or any of the attorneys below who contributed to this Update, or who are part of our securities group listed at <http://www.hhlaw.com/secattorneys/>.

Peter J. Romeo (Co-Editor)

pjromeo@hhlaw.com

Henry D. Kahn

hdkahn@hhlaw.com

Richard J. Parrino (Co-Editor)

riparrino@hhlaw.com

Stuart G. Stein

sgstein@hhlaw.com

www.hhlaw.com

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SEC update

Furnishing of Earnings Releases on Form 8-K

January 28, 2003

On January 15, the SEC adopted a final rule under Section 409 of the Sarbanes-Oxley Act that requires public companies to furnish on Form 8-K earnings releases and similar announcements publicly disclosing material non-public information for completed quarterly or annual fiscal periods. The final rule differs from the proposed rule by (1) requiring earnings releases and similar announcements on Form 8-K to be "furnished" to, rather than "filed" with, the SEC and (2) extending the Form 8-K deadline from two to five business days after a company first issues an earnings release or makes a similar public announcement. The new rule is published in Release No. 34-47226 (dated January 22) and will apply to earnings releases and similar announcements made after March 28, 2003. In the same release, the SEC adopted rules that impose requirements with respect to the use of non-GAAP financial measures in earnings releases and SEC filings. These rules will be discussed in a separate *SEC Update*.

Summary of the Rule

Section 409 of the Sarbanes-Oxley Act directs the SEC to require public companies to file "on a rapid and current basis" information concerning material changes in the company's financial condition or operations. The new rule amends Form 8-K to add a new Item 12, which is captioned "Disclosure of Results of Operations and Financial Condition." Under the rule, public companies will be required to furnish to the SEC a report on Form 8-K under Item 12 in which they:

- "Briefly identify" public announcements or releases containing material non-public information regarding the company's results of operations or financial condition for a completed quarterly or annual fiscal period; and
- Include the text of the announcement or release as an exhibit.

The new rule will apply only if a company chooses to issue an earnings release or make a similar announcement. Accordingly, companies will continue to be free to decide whether to issue such releases and announcements. The new rule will not apply to foreign private issuers that submit information on Form 6-K.

Information to be Furnished. The Form 8-K requirement will be triggered by the first public disclosure of material non-public financial information regarding a quarterly or annual fiscal period that has ended. Subsequent publications of the same information will not necessitate additional Form 8-K reports, unless the publications include updated or additional material non-public information about the applicable fiscal period. Because the Form 8-K requirement will apply only to public disclosure of information concerning a quarterly or annual fiscal period that has ended, it will not apply to disclosure of earnings estimates or other "forward-looking information" for continuing or future fiscal periods, unless those estimates are included in a public release or announcement that also discloses information regarding a completed quarterly or annual fiscal period. If the requirement is triggered by information in a company's interim or annual report to shareholders, the company may file the entire report as an exhibit to the Form 8-K and specify under Item 12 the portion of the attached report required to be furnished under Item 12. The Form 8-K requirement will not apply to disclosures that are made solely in a quarterly report on Form 10-Q (or 10-QSB) or an annual report on Form 10-K (or 10-KSB) filed with the SEC.

In an exception for earnings calls and similar presentations, a Form 8-K report under Item 12 will not be required for presentations of material non-public information for completed quarterly or annual fiscal periods that are made orally, telephonically, by webcast, by broadcast or by similar means if the following four requirements are met:

1. The information is provided as part of a presentation that is "complementary" to, and initially occurs within 48 hours after, a related, written release or announcement that has been furnished to the SEC under Item 12 of Form 8-K before the presentation (which would be before the five-day deadline otherwise applicable to the related, written release or announcement);
2. The presentation is broadly accessible to the public by dial-in conference call, by webcast, by broadcast or by similar means;
3. The financial and other statistical information included in the presentation, together with any information required under Regulation G (the SEC's new disclosure regulation), is provided on the company's web site; and
4. The presentation was announced in advance by a widely disseminated press release that included instructions concerning when and how to access the presentation and where to find the information on the company's web site.

In the adopting release, the SEC emphasized the requirement that, consistent with current practices, the presentations must include information that is "complementary" to the information in the related, written release or announcement, and that the exception to Item 12 disclosure is not intended to encourage companies to shift disclosure from the written release or announcement to the complementary presentation.

If the earnings release or other announcement furnished on Form 8-K contains non-GAAP financial measures, companies must disclose the following either in the release or announcement itself or under Item 12 of Form 8-K:

- (1) The reasons why the company's management believes that presentation of any non-GAAP financial measures provides useful information to investors regarding the company's financial condition and results of operations; and
- (2) To the extent material, any additional and otherwise undisclosed purposes for which the company's management uses the non-GAAP financial measures.

A company also may satisfy these disclosure requirements by including the required information in its most recent annual report filed with the SEC (or in a more recent filing) and by updating that information, as necessary, no later than the time the company furnishes the Form 8-K report to the SEC.

Timing of Form 8-K Report. Companies generally will have to furnish the Item 12 information on Form 8-K not later than the fifth business day after the date on which the company first makes the triggering public disclosure. As noted above, however, the company must furnish the Item 12 information before it makes a "complementary" presentation of material non-public information in an earnings call or by similar means, if it wishes to avoid furnishing a Form 8-K report with respect to the complementary presentation. The SEC cautioned in the adopting release that it may shorten the five-day deadline to two business days if and when it adopts its pending proposal, set forth in Release No. 34-46084 (June 17, 2002), to shorten the filing deadline for all reports on Form 8-K to two business days.

"Furnishing" Versus "Filing" Form 8-K. As proposed, Item 12 would have required companies to "file" a Form 8-K meeting the requirements of Item 12. The final rule, however, states that earnings releases and similar Item 12 disclosures will be "furnished" to, rather than "filed" with, the SEC, unless the company specifically states that the information is to be considered "filed" under the Exchange Act or incorporates the information by reference into a filing under the Securities Act or Exchange Act. The new rule is consistent with the approach adopted with respect to Regulation FD disclosures under Item 9 of Form 8-K, which similarly are deemed to be "furnished" to the SEC. Accordingly, Item 12 information that is furnished to the SEC will not be subject to the liability of Section 18 of the Exchange Act (unless the company specifically states that the information is to be considered "filed") and will not be incorporated by reference into a registration statement, proxy statement or other report (unless the company specifically incorporates the information into those documents by reference).

Relationship of Item 12 to Regulation FD

The adopting release notes that earnings releases and similar disclosures that will trigger the requirements of Item 12 are also subject to Regulation FD, which requires a company that discloses material non-public information to market professionals simultaneously to communicate that information to the public. ("Non-intentional" disclosures of material non-public information should be communicated to the public promptly, which generally means within 24 hours.) To satisfy Regulation FD, the communication must be made in a manner designed for broad distribution, which may (but is not required to) include filing the information on Form 8-K under Item 9. A Form 8-K furnished to the SEC under Item 9 would satisfy a company's obligation under Regulation FD only if the company furnishes the Form 8-K within the period required by Regulation FD. If a company decides to satisfy Regulation FD by furnishing a Form 8-K report in connection with a public disclosure that also triggers the requirements of Item 12, it will be able to satisfy the requirements of both Regulation FD and Item 12 with a single Form 8-K report if it furnishes the report within the period required by Regulation FD, if the report otherwise satisfies the requirements of both Item 9 and Item 12, and if the report indicates that it is being furnished under both Item 9 and Item 12. If the company satisfies Regulation FD in connection with such a public disclosure

other than through a Form 8-K report that meets the requirements of Regulation FD, it would have to furnish the Item 12 information on Form 8-K within the five-day deadline prescribed by the new rule.

Analysis

In the final rule, the SEC responded to the concerns of some commenters that requiring the Item 12 information to be filed with, rather than furnished to, the SEC, would increase the exposure of public companies to potential securities-law liability and could discourage some companies from issuing earnings releases or making similar announcements. The principal effect of the new rule will be to increase public access to earnings releases and similar announcements representing the initial public disclosure of material information regarding a company's results of operations or financial condition for a completed quarterly or annual fiscal period. Companies will have to incorporate the new disclosure requirements and reporting deadlines into their compliance procedures. In particular, careful planning will be required to ensure availability of the reporting exception for information communicated in earnings calls and similar presentations.

For more information about the matters discussed in this *SEC Update*, please contact the Hogan & Hartson L.L.P. attorney with whom you work, any of the attorneys below who contributed to this *Update*, or any of the members of our securities group listed at <http://www.hhlaw.com/secattorneys>.

Peter J. Romeo (Co-Editor)

pjromeo@hhlaw.com

Charles E. Sieving

cesieving@hhlaw.com

Richard J. Parrino (Co-Editor)

rjparrino@hhlaw.com

www.hhlaw.com

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SEC update

Disclosure of "Audit Committee Financial Expert"

January 27, 2003

On January 15, the SEC adopted final rules under Section 407 of the Sarbanes-Oxley Act, which requires public companies to disclose whether the audit committee of the board of directors has at least one member who is a "financial expert." The new rules adopt a less restrictive approach than the SEC's proposal issued on October 22, 2002 concerning the attributes of a financial expert and the manner in which the financial expert must have acquired these attributes. The rules are set forth in Release No. 34-47235 (as amended on January 24, 2003) and are effective 30 days after their publication in the Federal Register. Public companies (other than small business issuers) must comply with the new disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply with the disclosure requirements in their annual reports for fiscal years ending on or after December 31, 2003.

Required Company Disclosure

Section 407 of the Act directs the SEC to adopt rules requiring public companies to disclose in their periodic reports whether the company's audit committee has at least one member who is a "financial expert" as defined by the SEC and, if not, the reasons why the audit committee lacks a financial expert. (The new rules use the term "audit committee financial expert" to emphasize that the director's attributes are those relevant to audit committee functions.) The new rules expand upon the Act's basic disclosure directive by requiring companies also to disclose (1) the name of the director serving on the audit committee whom the board of directors has determined to be an audit committee financial expert and (2) whether the expert is "independent" of management. If the board of directors has not determined that at least one member of the audit committee is an audit committee financial expert, the company would have to disclose that fact. Similarly, if an audit committee financial expert does not qualify as independent, the company would be required to explain why. If a company determines that more than one audit committee member qualifies as an audit committee financial expert, the company may, but is not required to, disclose the names of the additional experts.

The independence of an audit committee financial expert for purposes of the required disclosure would be determined on the same basis as in the SEC's proxy rules. The proxy rules currently refer, for both listed and unlisted companies, to the independence requirements contained in the listing standards of the New York Stock Exchange, the American Stock Exchange and NASDAQ. Section 301 of the Act directs the SEC to adopt rules directing the exchanges and NASDAQ to apply certain concepts of independence to all listed companies. The exchanges and NASDAQ likely will be revising their definitions of independence to conform to the SEC rules under Section 301, which the SEC proposed on January 8, 2003 and must adopt by April 26, 2003.

Although Section 407 of the Act directed that the disclosure regarding financial experts be included generally in periodic reports, the new rules require the disclosure only in the company's annual report on Form 10-K, 10-KSB, 20-F (for foreign private issuers) or 40-F (for certain Canadian issuers). A company filing on Form 10-K or Form 10-KSB can comply with the disclosure requirement by providing the required information voluntarily in the company's proxy statement and incorporating that information by reference into the company's annual report, so long as the proxy statement is filed within 120 days after the end of the company's fiscal year. The SEC has designated the new disclosure item as Item 401(h) of Regulation S-K and Item 401(e) of Regulation S-B.

Who Must Disclose

With a few exceptions, the audit committee financial expert disclosure requirements apply to all public companies, not just those listed on the New York Stock Exchange or the American Stock Exchange or those quoted on NASDAQ. The exchanges and NASDAQ have their own requirements for the financial expertise of audit committee members, and listed companies will have to comply with both the SEC rules and the applicable exchange or NASDAQ requirements. The exchanges and NASDAQ, which are revising their rules in several areas to comply with the requirements of the Act, may modify their "financial expertise" requirements in light of the new SEC rules under Section 407.

The applicable definition of "independence" is expected to change in response to the dictates of Section 301 of the Act. As a result, the SEC rules under Section 407 do not require foreign private issuers to disclose whether the audit committee financial expert is independent, although that disclosure will be required when the SEC adopts final rules implementing Section 301. The SEC's proposed rules under Section 301 contain an exemption from the audit committee independence standards for certain foreign private issuers that operate with a board of auditors or statutory auditors instead of with a U.S.-style audit committee, and the SEC has requested comment on whether these issuers should have a similar exemption from the disclosure requirements concerning audit committee financial experts.

The new disclosure requirements under Section 407 do not apply to asset-backed issuers or, at the present time, to registered investment companies. The SEC will adopt final rules applicable to registered investment companies at a later date.

Definition of "Audit Committee Financial Expert"

The SEC received a significant number of comments arguing that the proposed rules were too restrictive concerning the attributes of a financial expert and the manner in which the financial expert must have acquired these attributes. The final rules modify the proposed definition of audit committee financial expert in a way that should expand the class of potentially qualified directors. The full board of directors must make the determination of

whether an audit committee member qualifies as an audit committee financial expert. Under the final rules, a director must possess all five of the following attributes to qualify:

1. An understanding of generally accepted accounting principles ("GAAP") and financial statements;
2. The ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
3. Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
4. An understanding of internal controls and procedures for financial reporting; and
5. An understanding of audit committee functions.

The audit committee financial expert must have acquired those attributes through any one or more of the following means:

- (1) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- (2) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- (3) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- (4) Other relevant experience.

If a board determines that the audit committee financial expert acquired the necessary attributes through "other relevant experience," the company's disclosure must identify that experience. The SEC stated that the audit committee financial expert need not have attained the necessary attributes through experience with another U.S. public company, since other companies, such as many privately held companies or foreign public companies, also prepare audited financial statements. The SEC also clarified that an understanding of GAAP refers to the GAAP used to prepare the company's primary financial statements. Accordingly, a non-U.S. company that prepares its financial statements under its home country GAAP with a reconciliation to U.S. GAAP would not be required to have an audit committee financial expert who also is familiar with U.S. GAAP.

In its proposed rules, the SEC listed a number of factors that boards should consider in assessing whether a director possesses the necessary attributes to be considered an audit committee financial expert. The SEC stated that it has omitted this list of factors from the final rules out of concern that it would limit boards of directors in considering all relevant facts and circumstances, and would be used as a mechanical checklist rather than for the guidance it was intended to provide.

Safe Harbor from Liability

In the adopting release, the SEC reaffirmed its position that the mere designation or identification of an audit committee financial expert will not increase the duties, obligations or liability of that director as an audit committee member. To "codify" this position, the SEC has included a "safe harbor" in the new rules, which it states is intended to clarify that the designation or identification of a director as an audit committee financial expert will not:

- Cause that director to be deemed an "expert" for any purpose, including, without limitation, for purposes of Section 11 of the Securities Act of 1933. (Designation as an "expert" for purposes of that section of the Securities Act might have the effect of increasing the "due diligence" obligations of the audit committee financial expert, and decreasing the "due diligence" obligations of other directors, in a registered securities offering);
- Impose on that director any duties, obligations or liabilities that are greater than those otherwise imposed on the director as a member of the audit committee or board of directors; or
- Affect the duties, obligations or liabilities of any other member of the audit committee or board of directors.

Analysis and Recommendations

Consistent with the disclosure-based approach of Section 407, the SEC's rules do not require public companies to have an audit committee financial expert, but simply require companies to disclose that they do, or do not, have such an expert. Many companies, however, will not want to make the statement that no member of the audit committee is an audit committee financial expert. Further, corporate governance "best practices" may dictate that at least one member of the audit committee qualify for that designation, and the New York Stock Exchange and NASDAQ may act to require their listed companies to have an audit committee financial expert.

Companies with calendar-year fiscal years will not have to include the required disclosures about their audit committee financial experts until their 2003 annual reports. Any company that wants to designate an audit committee financial expert, however, should begin assessing the qualifications of its current audit committee members and, if necessary, commence a search for individuals with the required attributes. Finding a qualified audit committee member should be somewhat easier under the final rules than under the proposed rules, since the requirements have been relaxed in two key areas. First, the final rules place less emphasis on specialized technical knowledge and direct experience in actually preparing or auditing financial statements and permit the acquisition of the required attributes through experience in assessing, evaluating or supervising such activities. The supervisory experience must still be active, "hands on" experience, however, and the SEC stated that a CEO with extensive operations experience but little financial or accounting involvement likely would not meet this requirement. Second, the final rules modify the proposed requirement that the audit committee financial expert have experience with financial statements that present accounting issues generally comparable to those applicable to the company's financial statements. The SEC's proposal appeared to require a background of experience in a similar industry, which would have made it more difficult to find qualified individuals, particularly for companies in industries with specialized accounting rules. The final rules clarify that the required experience need not be industry-based, but instead must simply be with financial statements that present issues of comparable breadth and level of complexity.

Although the final rules are less restrictive than the SEC's original proposal and place more reliance on the board of directors' judgment in assessing a candidate's attributes, finding qualified individuals who are willing to serve as audit committee financial experts will still be challenging. The new safe harbor from liability should be helpful in alleviating the concerns of potential financial experts, although the directors filling that role will have a level of visibility that some candidates may find unwelcome. The safe harbor contains cautionary language reminding other audit committee members that the designation of an audit committee financial expert does not relieve them of their responsibilities as committee members and directors.

For more information about the matters discussed in this *SEC Update*, please contact the Hogan & Hartson L.L.P. attorney with whom you work, or any of the attorneys below who contributed to this *Update*, or who are part of our securities group listed at <http://www.hhlaw.com/secattorneys/>.

Peter J. Romeo (Co-Editor)

pjromeo@hhlaw.com

Sandra Folsom Kinsey

sfkinsey@hhlaw.com

Richard J. Parrino (Co-Editor)

rjparrino@hhlaw.com

www.hhlaw.com

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